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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1946.

No. 133

JOHN H. CHATZ, Trustee in Bankruptcy of Hoagland & Allum Co., Inc.,
Petitioner,

vs.

MIDCO OIL CORPORATION, a corporation,
Respondent.

PETITIONER'S REPLY BRIEF.

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CHAMPLIN-SHEALY COMPANY, CHICAGO 365

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Summary of Argument.

A.

The basic point, consistently urged by this petitioner in both lower courts, viz:—that the respondent corporation stood in a fiduciary relation towards its stockholders whose shares of stock it acquired, and was required to maintain the burden of proof of a valid purchase, in full compliance with statutory requirements, has been completely ignored by those courts, and has not been answered in the brief of respondent. This proposition presents the very heart of this case, and it was improper for the lower courts to fail to adjudicate it.

B.

The cited statute of Oklahoma was affirmatively placed in issue by the respondent when it asserted in its answer that this purchase was "effectual * * * under the pertinent laws of Oklahoma" (R. 34). This presents a proposition of law, not of evidence. The record is complete, and this Court has the power to consider all legal questions affecting the validity of this transaction.

C.

The respondent abandoned its plea of the statute of limitations at the trial, and cannot now urge it in this Court. This defense would not apply in any event, as this is an action for fraud, perpetrated by a fiduciary; the statute of limitations did not begin to run until the fraud had been discovered. Statutes of Limitations are never applied by courts of equity to protect fraud.

This action is predicated under Sections 60e (relating solely to bankrupt stockbrokers) and 70e of the Bankruptcy Act; the rights of the bankrupt's customers to assert their respective individual rights and actions for recovery is now lodged exclusively in trustees in bankruptcy, such as petitioner, in this proceeding.

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MIDCO OIL CORPORATION, a corporation,

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PETITIONER'S REPLY BRIEF.

A.

The respondent corporation as a fiduciary of its stockholders was required to maintain the burden of proof of a valid purchase, including full compliance with the quoted requirements of the statutes of Delaware and Oklahoma. This purchase was in direct violation of these statutes and is utterly void.

Counsel for respondent base their main argument (beginning on page 15) on the proposition that officers and directors of a corporation owe no fiduciary duty to the

corporation's stockholders in respect to their individual purchases of stock from the stockholders. That is not the point in this case. This case relates to a purchase by the issuing corporation of stock belonging to its stockholder. The corporation is itself a fiduciary of its stockholders. Counsel for respondent misled the Circuit Court of Appeals into deciding this case in accordance with *Securities and Exchange Commission* v. *Cheney Corp.*, 318 U. S. 80, which has no factual resemblance to this case.

We are not contesting a transaction which concerns solely a corporate officer or director acting in his individual capacity and in his own behalf, with one or more stockholders of this corporation, as the respondent would have this Court to believe, from their argument and cited cases. Our controversy concerns the right of the *issuing corporation* to acquire and retain stolen shares of stock belonging to its *stockholders,* which it purchased in disregard and in violation of its fiduciary obligation to its stockholders and in utter disregard of statutory prohibitions against any stock purchase, except under specified circumstances. Obviously, what the Circuit Court of Appeals decided was not the issue as squarely presented to that Court. The applicable prohibitions and limitations contained in the Delaware and Oklahoma Statutes, as quoted in this petitioner's main brief, relate to purchases of the corporation's stock by the issuing corporation. Those statutes place no limitations upon any purchases by the corporation's officers and directors. This purchase was made by the issuing corporation, it was inhibited from making this purchase, as was heretofore pointed out, so consequently, the purchase was utterly void. Respondent has not answered this argument, for there is no answer.

Although it is abundantly clear from this record that the purpose for this purchase was to protect Toomey's

position as president and director of the company, nevertheless the actual purchase was made by the corporation, with corporate funds, without notice to stockholders. It is unquestionable that Mr. Toomey's relations towards the stockholders was likewise fiduciary, at the time of this purchase.

Can there be a shadow of doubt that the duty of the corporation in its relations towards its stockholders in respect to the corporate property and the stock which represents the interests of the stockholders in the corporate property, was fiduciary? If that is conceded, as it must be, then it naturally follows that in a controversy between the fiduciary and the cestuis que trust, the stockholders, respecting the subject matter of the trust, the burden is on the fiduciary to establish a valid purchase; this necessarily includes proof of compliance by the fiduciary with all statutory requirements governing the purchase of the trust property, without which no valid purchase can be claimed by the fiduciary. This is a simple statement of applicable basic law which this petitioner has consistently urged, the respondent deftly avoided answering, and which the Circuit Court of Appeals utterly failed to pass upon. The error thus committed by the Circuit Court of Appeals was unavailingly called to that Court's attention in the petition for rehearing (R. 458).

In addition to the authorities quoted in petitioner's main brief, there is cited on page 22 a list of authorities supporting the rules for which petitioner contends. To be of further assistance to this Court, and to show the uniformity of the rules contended for, the following quotations from three of the cases cited should be very helpful:

Holly Corporation v. *Wilson,* 101 Col. 513, at page 519:

> "A corporation is a trustee for its stockholders, and is bound to protect their interests. It holds its prop-

> erty as trustee for its stockholders. A stockholder has the right, therefore, to rely upon the fact that the corporation will preserve his right to his stock, and to presume that it will not assert an adverse claim to it."

Seymour v. *National Biscuit Co.* (C. C. A. 3), 107 F. (2d) 58, at page 63:

> "• • • the law is nonetheless settled that a corporation stands in the relation of a fiduciary to its stockholder."

Allman v. *Salem Building Association,* 275 Ill. 336, on page 341:

> "But a corporation is by law the custodian of the shares of its stock and clothed with power sufficient to protect the rights of everyone interested therein from unauthorized transfers, and, like every other trustee, it is bound to execute the trust with proper diligence and care, and is responsible for an injury sustained by its negligence or misconduct in making transfers or cancellations of such stock."

The rule as to the burden of proof is further supported in *Franklin* v. *Mortgage Guaranty & Security Co.* (C. C. A. 9), 57 Fed. (2nd) 834, where on page 838 the Court said:

> "We agree with the appellant that generally the burden of proof to show fraud is upon him who alleges it. We believe that this burden has here been amply sustained, particularly in view of the fact that, once a fiduciary relation is established, the burden rests upon the trusted agent to show full disclosure of all transactions attacked."

The foregoing quotations as respects the facts in this case indicate clearly that the District Court and the Circuit Court of Appeals failed to correctly apprehend the essential aspects of this proceeding and the rules of law applicable thereto. The trial court said in its oral decision:

> "The only question for me to decide here is whether or not good faith was exercised and honesty of purpose was displayed by Mr. Toomey at the time, for and on behalf of this corporation, he acquired these 2000 shares of stock." (R. 275.)

Practically the identical phraseology was contained in the conclusions of law submitted by respondent and entered by the trial court, as follows:

> "The only question for decision is whether good faith was exercised and honesty of purpose displayed by the purchaser in the acquisition of the 2000 shares." (R. 429.)

The Circuit Court of Appeals substantially approved the limitations of this finding (R. 451).

Among the conclusions of law this petitioner presented to the trial court for consideration and adoption are the following:

> "8. In a controversy between the issuing corporation and its stockholders, respecting the propriety and validity of the purchase by the corporation of shares of stock belonging to the stockholders, the burden of showing fair dealing towards the stockholders is upon the corporation." (R. 423.)

and

> "20. The fiduciary relationship between Midco Oil Corporation and its stockholders, having existed, as a matter of law, the burden of proving fair dealing toward said stockholders with respect to the shares of stock in question, was upon the defendant, Midco Oil Corporation. Said defendant has failed to maintain the burden of proof." (R. 425.)

The District Court erroneously failed to adopt these applicable conclusions of law and the Circuit Court of Appeals, in its decision, ignored these rules of law, limiting this aspect of its decision to a discussion of the obligation of officers and directors towards stockholders whose

stock they were purchasing. That is not the controlling point in this case. The above quoted propositions of law submitted by this respondent and which are directly applicable to the facts in this case, are still unanswered.

As heretofore pointed out, Mr. Toomey, the respondent's president, negotiated for this fraudulent purchase, but the purchase was made by the corporation, with its own funds (R. 240, 304), without the unanimous consent of the stockholders in writing, as the Oklahoma statute requires, and not with surplus funds as both the Delaware and Oklahoma statutes require; at that time the respondent's admitted deficit was close to $1,000,000.00.

The funds of the corporation which were used to purchase this stock and to perpetrate the fraud were the funds of the stockholders, held in trust by the corporation. The actual theft of these 2,000 shares by the bankrupt did not occur until *after* the receipt of the offer from Lahman, the corporation's agent and intermediary, to purchase this stock. As a matter of fact, it appears in this record that Lahman's offer to the bankrupt was made on August 31, 1937 (R. 199, 307) and that the stock was stolen for that purpose by the bankrupt on September 1, 1937, when Engel brought an additional 700 shares of this stolen stock to his bank (R. 209), ostensibly to make a further loan thereon, but actually for the purpose of having all the certificates guaranteed by the bank as to signatures, and then, simultaneously, directed the bank to forward all the certificates on the same day to the respondent's bank in Tulsa (R. 209, 381). It is highly significant that the bank's guarantees as to signatures were all placed upon these certificates on September 1, 1937 (R. 299, 301), after the receipt of the two telegrams of August 31, 1937, confirming the purchase of these 2,000 shares of stock by Mr. Lahman, respondent's agent (R. 377, 378). The im-

portance of this evidentiary matter is to point out that the respondent's agent's offer to purchase this stock was the actual inducement for the theft by the bankrupt.

If this was not a highly questionable transaction, why was it necessary for the respondent to employ an agent (who was not a stock broker) to make this purchase and to pay him $2,000.00, rather than to negotiate for itself? Why was its identity kept secret and undisclosed? Why was it necessary to deposit a secret letter of instructions with the bank in Tulsa (R. 386), and why was Mr. Toomey referred to as "Lahman's Advisor" in a telegram from the bank in Tulsa to the bank in Chicago? (R. 382) This conduct is nevertheless urged by the respondent, here and throughout this record, as a purchase "in good faith," and "in the ordinary course of business." Does not this secrecy demonstrate that the respondent knew or had reason to know that this transaction was corrupt? The transaction was so extraordinary, that on cross-examination by respondent's counsel, Mr. Engel, who had many years' experience as a stock broker and handled this transaction, said:

> "We never had a transaction like that before, if you mean about selling securities that were owed until—"
>
> • • •
>
> "That is the only transaction I ever had of that nature."
>
> • • •
>
> "The only one I was ever mixed up with." (R. 211.)

As further evidence of the secret and fraudulent nature of this transaction, the record discloses that on April 21, 1938, one Emil Soeth, who had been the owner of seven certificates of this stock for a total of 118 shares, wrote to this respondent inquiring about his stock (R. 351). The respondent replied by letter of April 26, 1938 that his

certificates were "transferred to the present owner on September 3, 1937" (R. 352). Mr. Soeth pressed his inquiry by his letter dated June 7, 1938, in which he inquired "who sold a lot of my stock without my consent" (R. 353), to which the respondent replied by letter dated June 10, 1938, in which it falsely and fraudulently said to him: "We have contacted the purchaser of your 118 shares, which you formerly owned, and find that he bought this stock from Henry Engel of Hoagland, Allum & Company, located in Chicago" (R. 353). The following questions were propounded to Mr. Toomey on the trial of this case with respect to the last mentioned letter and he made these replies:

"Q. Now, who did you contact to make that reply?
A. I did.
Q. Who did you contact?
A. I contacted the purchaser.
Q. Who is the purchaser?
A. The Midco Oil Corporation.
Q. Who wrote this letter?
A. Miss Wade.
Q. Isn't it signed 'Midco Oil Corporation'?
A. Yes, sir.
Q. Isn't that the one who was the then owner of the stock?
A. That is correct.
Q. Did you have to go outside of your office to contact the purchaser of the stock?
A. No." (R. 259.)

B.

The laws of Oklahoma were placed in issue by the respondent as an affirmative defense, which it failed to maintain. As the record is complete, this Court has inherent power to consider the cited statutes of Delaware and Oklahoma. This stock purchase cannot be valid under any theory, as it was consummated in direct violation of both of these controlling statutes.

The respondent had the inescapable burden of establishing the validity of this stock purchase as a primary duty in its defense. The respondent apparently recognized the necessity of carrying this burden at the time it prepared its answer, but thereafter it studiously avoided making the essential proof. Respondent's assertion in the Circuit Court of Appeals and in this court that the statute of Oklahoma was not in issue is an inaccurate statement. In its answer the respondent affirmatively asserted and defended this purchase as "effectual * * * under the pertinent laws of Oklahoma" (R. 34). The laws of Oklahoma were thereby directly placed in issue before the District Court and thus were properly in the record before the Circuit Court of Appeals, and are now before this Court. Respondent has nowhere in its brief denied the applicability of the statutes of Oklahoma and Delaware as cited in this petitioner's main brief; they have completely avoided answering, for, in fact, there is no answer.

The urging of the statutes of Delaware and Oklahoma is not a point of evidence but is a proposition of law, the non-observance of which nullifies the transaction in question. This stock purchase could not be valid under any theory urged by the respondent unless it made affirmative proof that it complied with these statutory requirements, which it completely failed to do.

If, in fact, this had been a new point, raised for the first time on appeal, as the respondent urges and as the Circuit Court of Appeals held (the correctness of which contention petitioner denies), nevertheless the point was of such nature that a court of review, as a matter of judicial discretion, has the power to consider. This Court, in *Langnes* v. *Green,* 282 U. S. 531, said at page 541:

> "The term 'discretion' denotes the absence of a hard and fast rule. *The Styria* v. *Morgan,* 186 U. S. 1, 9. When invoked as a guide to judicial action it means a sound discretion, that is to say, a discretion exercised not arbitrarily or wilfully, but with regard to what is right and equitable under the circumstances and the law; and directed by the reason and conscience of the judge to a just result."

A well reasoned analysis of parallel circumstances and the rules of law applicable thereto was discussed by the Supreme Court of Wisconsin in *Cappon* v. *O'Day,* 165 Wis. 486; the Court said beginning at page 490:

> "Respondent claims in his supplementary brief that, the question of the validity of the mortgage not having been raised, the record is conclusive upon this court, and for this court to now consider the question would amount to a perpetration of a gross wrong and hardship upon the plaintiff and imposition upon the trial court.
>
> We cannot agree with this contention. This court sits here to do justice between litigants. For the purpose of orderly administration and the attainment of justice certain rules are established. Any rule the enforcement of which results in a failure of justice should be carefully scrutinized and not blindly adhered to, unless the abandonment of it will work more injustice than will follow if it be adhered to. One of the rules of well nigh universal application established by courts in the administration of the law is that questions not raised and properly presented for review in the trial court will not be reviewed on appeal. 3 Corp. Jur. 689. The reason for the rule is plain. If

the question had been raised below, the situation might have been met by the opposite party by way of amendment or of additional proof. In such circumstances, therefore, for the appellate court to take up and decide on an incomplete record questions raised before it for the first time would, in many instances at least, result in great injustice, and for that reason appellate courts ordinarily decline to review questions raised for the first time in the appellate court. But to this rule there are many exceptions. Questions as to the jurisdiction of the court may be raised. *Telford* v. *Ashland,* 100 Wis. 238, 75 N. W. 1006. Questions as to the legal effect of a deed or other instrument may be raised for the first time in this court. *Hartung* v. *Witte,* 59 Wis. 285, 18 N. W. 175; *Nightingale* v. *Barens,* 47 Wis. 389, 2 N. W. 767. There are numerous other exceptions. 3 Corp. Jur. 740. No question of the power of this court is involved. Whether this court should review a question raised here for the first time depends upon the facts and circumstances disclosed by the particular record. It undoubtedly has the power, but ordinarily will not exercise it. The question is one of administration, not of power. The statements in *Will of Brandon,* 164 Wis. 387, 160 N. W. 177, and *Ritter* v. *Ritter,* 100 Wis. 468, 76 N. W. 347, to the effect that questions not brought up in the court below cannot be considered here, must be considered as statements of the general rule to which there are exceptions as here indicated.

In this case the question as to the validity of the mortgage has been fully argued. It is not claimed that the facts do not fully appear. The record is complete."

Likewise in this case, the record is complete; the rules of law urged by this petitioner are applicable, controlling and conclusive.

C.

The plea of the statute of limitations was heretofore abandoned by the respondent and cannot now be urged. In fraud actions, the statute of limitations does not begin to run until after discovery of the fraud. In an equity action such as this, against a defrauding fiduciary, courts of equity recognize no statute of limitations where its enforcement would tend to assist in protecting the fraud.

The plea of the statute of limitations was completely abandoned by the respondent at the trial of this case. Nowhere in the conclusions of law was the District Court asked to rule upon this point. What the "court could have found" as suggested on page 21 of respondent's brief is not open to conjecture. The respondent then urged the court to find as a matter of law, and the court did find that:

> "The only question for decision is whether good faith was exercised and honesty of purpose displayed by the purchaser in the acquisition of the 2,000 shares." (R. 429.)

Had this question still been an open one, the pronouncement by this Court in *Herget* v. *Central National Bank & Trust Company of Peoria,* 324 U. S. 4, cited by respondent on page 21, would not apply, as this Court there had under consideration a suit for the recovery of a preferential transfer under Section 60 of the Bankruptcy Act. This action is grounded on Sections 60e and 70e of the Bankruptcy Act (R. 9). Neither of those sections were discussed in the *Herget* case. Section 60e, which was enacted under the Act of June 22, 1938 and became effective as part of the Bankrutcy Act on September 22, 1938, relates solely to liquidation of bankrupt stockbrokers. None

of the prior bankruptcy acts contained the provisions of Section 60e. The rights which individual customers of bankrupt stockbrokers theretofore had, to enforce their respective claims separately, in their own right, is now lodged solely in trustees in bankruptcy, such as the petitioner in this proceeding. Under paragraph 2 of said Section 60e it is provided:

> "All property at any time received, acquired, or held by a stockbroker from or for the account of customers, except cash customers who are able to identify specifically their property in the manner prescribed in paragraph (4) of this subdivision, and the proceeds of all customers' property rightfully transferred or unlawfully converted by the stockbroker, shall constitute a single and separate fund; and all customers except such cash customers shall constitute a single and separate class of creditors, entitled to share ratably in such fund on the basis of their respective net equities as of the date of bankruptcy. * * *"

Paragraph 5 of said Section 60e provides, in part:

> "* * * a transfer by a stockbroker of any property which, except for such transfer, would have been a part of such fund, may be recovered by the trustee for the benefit of such fund, if such transfer is voidable or void under the provisions of this Act."

Section 70e, which is the "Voidable Transfer" provision of the Bankruptcy Act, provides:

> "(1) A transfer made or suffered or obligation incurred by a debtor adjudged a bankrupt under this Act which, under any Federal or State law applicable thereto, is fraudulent as against or voidable for any other reason by any creditor of the debtor, having a claim provable under this Act, shall be null and void as against the trustee of such debtor."

It will therefore be observed that Sections 60e and 70e relate to the manner of enforcing *existing rights and lia-*

bilities. What this Court determined in the *Herget* case was an action under Section 60, where, as this Court said:

> "• • • the federal Bankruptcy Act created the liability • • •."

It is admitted in this record that the respondent did not inform its stockholders of this purchase, either before or after its consummation. It is equally apparent from the correspondence between the respondent and Mr. Soeth, one of its sotckholders, heretofore alluded to, that the respondent fraudulently concealed from the stockholders the fact of this purchase. The averment in petitioner's complaint that the information which established the existence of this cause of action came to the attention of petitioner subsequent to the filing of the original complaint herein (R. 9), has not been contradicted. Under these circumstances, the applicable section of the Illinois statute of limitations (Chapter 83, Ill. Rev. Stat. 1945) is as follows:

> "23, Fraudulent concealment. Sec. 22. If a person liable to an action fraudulently conceals the cause of such action from the knowledge of the person entitled thereto, the action may be commenced at any time within five years after the person entitled to bring the same discovers that he has such cause of action, and not afterwards."

The Oklahoma Statute of Limitations (Title 12, Sec. 93, third paragraph) similarly provides that in:

> "• • • an action for relief on the ground of fraud —the cause of action in such case shall not be deemed to have accrued until the discovery of the fraud."

The Supreme Court of Illinois discussed the proper application of the Statute of Limitation in *Gillett* v. *Wiley,* 126 Ill. 310, where on page 328 the court says:

> "In cases of fraud, the limitations will begin to run only from the discovery of the fraud, or from the time

when the fraud could have been discovered by the exercise of reasonable diligence; but it is well settled, that the failure to use such diligence may be excused when there exists a relation of trust and confidence between the parties, rendering it the duty of the party committing the fraud to disclose to the other the truth, and where it was through the acts of the former that the latter was induced to refrain from inquiry."

In *Blount* v. *Chicago Railway Equipment Co.*, 242 Ill. App. 69, at page 87, the Court said:

"On the contrary, the action is purely equitable and statutes of limitation have no application, except under circumstances that would appeal to the conscience of a court of chancery. A court of chancery does not apply such a statute ordinarily nor permit the defense of laches to be interposed in cases where a defendant has property in his hands which equitably belongs to a complainant."

In *Bates* v. *Preble*, 151 U. S. 149, at 160-161, this Court said:

"On the other hand, if the fraud itself be secret in its nature, and such that its existence cannot be readily ascertained, or if there be fiduciary relations between the parties, there need be no evidence of a fraudulent concealment other than that implied from the transaction itself."

In *Bailey* v. *Glover*, 21 Wall. (88 U. S.) 342, this Court said at page 349:

"To hold that by concealing a fraud, or by committing a fraud in a manner that it concealed itself until such time as the party committing it could plead the statute of limitations to protect it, is to make the law which was designed to prevent fraud the means by which it is made successful."

Conclusion.

Compliance by respondent with the controlling statutes of Oklahoma and Delaware, or of either of those states, and a semblance of regard for the rights of its stockholders, would have prevented the perpetration of this fraud. That the respondent corporation violated these statutes has not been denied in respondent's brief, nor can it be successfully denied. The respondent failed to maintain its burden of proof of a valid purchase in bar of its stockholders' rights to a recovery in this cause. As this purchase is in violation of the statutes and fixed equitable principals, it cannot be upheld as valid under any theory of law, for it is forever void; the District Court and the Circuit Court of Appeals erred in failing to so hold.

This petitioner respectfully urges this Honorable Court to issue its writ of certiorari as prayed, and to ultimately reverse the judgment in this cause.

Respectfully submitted,

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